

IN THE UNITED STATES COURT OF APPEALS  
FOR THE NINTH CIRCUIT

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TIM W. LILLIE and INGEBORG V. LILLIE,

Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

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PEARL LILLIE,

Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

---

ON PETITION FOR REVIEW OF THE DECISIONS OF THE  
TAX COURT OF THE UNITED STATES

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BRIEF AND APPENDIX FOR THE RESPONDENT

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FILED

OCT 20 1966

WM. B. LUCK, CLERK

RICHARD C. PUGH,  
Acting Assistant Attorney General.

LEE A. JACKSON,  
HARRY BAUM,  
STEPHEN H. PALEY,  
Attorneys,  
Department of Justice,  
Washington, D. C. 20530.



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FOR THE NINTH CIRCUIT

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No. 20915

TIM W. LILLIE and INGEBORG V. LILLIE,

Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

---

No. 20916

PEARL LILLIE,

Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

---

ON PETITION FOR REVIEW OF THE DECISIONS OF THE  
TAX COURT OF THE UNITED STATES

---

BRIEF AND APPENDIX FOR THE RESPONDENT

---

OPINION BELOW

The findings of fact and opinion of the Tax Court (I-R. 11-29) 1/  
are reported at 45 T.C. 54.

JURISDICTION

This petition for review (I-R. 33-38) involves federal income  
tax for the taxable years 1956, 1959, 1960 and 1961 in cause number

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1 / "I-R." and "II-R." references are to Volumes I and II of the

20915 (I-R. 30), and for the taxable year 1960 in cause number 20916 (I-R. 32). On August 23, 1963, the Commissioner of Internal Revenue mailed to the taxpayers in cause number 20915 a notice of deficiency for the taxable year 1956 in the amount of \$1,228.88 and negligence penalty of \$61.44; for the taxable year 1959 in the amount of \$4,200 and negligence penalty of \$210.04; for the taxable year 1960 in the amount of \$2,546.69, negligence penalty of \$127.33 and a delinquency penalty of \$254.17; and for the taxable year 1961 in the amount of \$3,552.23 and negligence penalty of \$177.61. Within ninety days thereafter, on October 31, 1963, the taxpayers in cause number 20915 filed a petition with the Tax Court for a redetermination of the deficiency under the provisions of Section 6213 of the Internal Revenue Code of 1954.

On April 1, 1964, the Commissioner of Internal Revenue mailed to the taxpayer in cause number 20916 a notice of deficiency for the taxable year 1960 in the amount of \$7,607.38. Within ninety days thereafter, on May 28, 1964, the taxpayer filed a petition with the Tax Court for a redetermination of the deficiency under the provisions of Section 6213 of the Internal Revenue Code of 1954.

Causes numbers 20915 and 20916, by joint motion of the parties, were consolidated for the purpose of trial and briefing. Decisions of the Tax Court were entered on January 20, 1966. (I-R. 30-32.) The case is brought to this Court by a petition for review filed March 2, 1966 (I-R. 33-38), within the three-month period prescribed in Section 7483 of the Internal Revenue Code of 1954. Jurisdiction is conferred on this Court by Section 7482 of that Code.

QUESTION PRESENTED

Whether the Tax Court correctly sustained the Commissioner's determination that large end-of-year payments by taxpayers for feed to be consumed and services to be rendered subsequent to the years of payment were not deductible as ordinary and necessary business expenses in the years of payment, but only in the years in which the feed and services were supplied.

STATUTE AND REGULATIONS INVOLVED

The pertinent provisions of the statute and Regulations involved are set out in the Appendix, infra.

STATEMENT

Tim W. and Ingeborg V. Lillie are husband and wife, residing in San Diego County, California. Pearl Lillie, mother of Tim, also resides in San Diego County, California. (I-R. 12-13.) 2/

Taxpayers keep their books and prepare their federal income returns on a calendar year basis and on the cash receipts and disbursements method of accounting. For the taxable years 1956 through 1961, the taxpayers filed their federal income tax returns with the District Director of Internal Revenue at Los Angeles, California. (I-R. 13.)

Tim is a dentist, and during the years in issue had a successful practice in the San Diego area. He reported net income from his dental practice as follows (I-R. 13):



<u>Year</u>	<u>Amount</u>
1956	\$26,778.25
1957	31,490.72
1958	28,058.91
1959	24,647.67
1960	10,244.54
1961	19,115.32

Tim reported net losses from a cattle business as follows (I-R. 13):

<u>Year</u>	<u>Amount of net (loss)</u>
1959	\$(29,176.83)
1960	(18,458.46)
1961	(6,683.84)

Tim's aggregate net income from his dental practice for the years 1959 through 1961 was approximately \$54,000 and his aggregate net loss from his cattle business for the same years was also approximately \$54,000. (I-R. 13.)

Pearl reported income in 1960 of \$21,226.93, which included interest payments received from Tim in the amount of \$18,444. On her 1960 federal income tax return she reported a net loss from cattle operations in the amount of \$20,402.12 of which \$19,700 was due to cattle feeding payments. (I-R. 14.)

During the years 1959, 1960, and 1961 Tim fed cattle for profit in Imperial County, California. Pearl joined him in his venture in 1960 and both have been actively engaged in the cattle business ever since. (I-R. 14.)

The cattle owned by taxpayers during these years were physically located in the commercial feed yards of Heber Cattle Feeders, 3/

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3 / Hereinafter referred to as Heber.



Heber, California, and McCabe Cattle Company, 4/ on the Dahlia Canal near El Centro, California. McCabe and Heber are cattle servicing companies whose principal source of income is derived from the sale of cattle feeds and services to their customers. To increase sales, these companies perform such complete services that some cattle owners never see their stock. McCabe and Heber purchase cattle for their customers and direct shipment to the company yards. When the cattle arrive, they are unloaded, branded, dipped, and weighed. Bulls are dehorned and castrated. The cattle are also recorded and placed in proper feeding pens. Throughout the months during which the cattle are being fattened, company employees mix the proper feeds and deliver them to the herds twice daily. After sale, the companies load the cattle and direct shipment to the purchasing meat packing houses.

(I-R. 14.) The value of the services rendered by the cattle feeding companies is substantial, but, rather than reflect them as such when billing customers, they have developed the general practice of including the cost of services in the sales price of their feeds.

(I-R. 15.)

The most frequently used feeds are silage, a basic feed used in the early growing stages, and finishing mixes, a name given to various blends of feed used to fatten steers to their maximum weight. The contents of these finishing feeds vary from company to company and can generally be said to grow more expensive as they contain those

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4/ Hereinafter referred to as McCabe.

elements which add the greatest finishing weight to the steer. (I-R. 15.)

Between December 13, 1959, and August 21, 1960, Tim maintained at Heber a herd of varying size which was identified as Lot No. 2. On December 21, 1959, Tim made a payment of \$25,000 to Heber and received as invoice reading, in part, as follows (I-R. 15):

\* \* \* for your purchase of the five hundred (500) tons of Number 1 feed for the cattle which you have placed with us to feed in our Lot #2 here at Heber Cattle Feeders.

\*

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\*

So that you may inform your bookkeeper or accountant of your transactions here in El Centro and Heber, I am listing below your account as of this date with us:

Feed (paid). . . 500 tons, #1 mix. . . \$25,000.00  
(Stored in east warehouse - Heber)

By December 31, 1959, Tim's cattle had consumed at Heber only \$657.65 of feed. During the year 1960 the cattle fed at Heber consumed \$32,704.74 of feed and Tim paid an additional sum of \$8,362.39 to Heber. (I-R. 15.)

Between November 14, 1960, and May 13, 1961, Tim maintained at McCabe two herds of varying size which were identified as Lots 117 and 137. On November 18 and December 31, 1960, Tim made payments of \$15,000 and \$27,160 respectively to McCabe, who recorded these amounts as feed sold to Tim in its books. The cattle in Lots 117 and 137 consumed \$3,244.59 of feed in 1960 and \$12,774.84 of feed in 1961 before being sold. (I-R. 16.)



During 1961, Tim had a disagreement with the managers of McCabe. Since he thought he could obtain more favorable treatment at Heber, he decided to transfer all of his business there. Consequently, on or about July 10, 1961 (some two months after the last of the cattle in Lots 117 and 137 had been sold), McCabe gave Tim a check for \$26,140.57 which represented the difference between Tim's payments (totaling \$42,160) and the total amount (\$16,009.94) of feed consumed by Lots 117 and 137 during 1960 and 1961. 5/ The termination of transactions between Tim and McCabe had not been envisioned the previous December when he had made his advance payments. No provision for the refund of the sums paid by Tim in November and December of 1960 had been made with McCabe. The check issued by McCabe represented the "credit balance due and payable" to Tim as shown on McCabe's statement of account dated July 10, 1961. (I-R. 16.)

Between July 5, 1961, and January 29, 1962, Tim maintained at Heber a herd of varying size which was identified as Lot No. 1. Between November 8, 1961, and May 14, 1962, he kept an additional herd at Heber which was identified as Lot No. 3. On December 29, 1961, Tim made a payment of \$52,520.23 to Heber. The cattle in Lots 1 and 3 consumed \$10,344.01 of feed in 1961. The balance of \$42,176.22, which was credited to Tim's account on December 31, 1961, was used for feed and services supplied in 1962. (I-R. 17.)

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5/ An additional \$9.49 was charged against Tim's payment as the fee for a branding inspection. (I-R. 16.)



On December 31, 1960, Pearl owned approximately 133 head of cattle which were identified as Lot 144 at McCabe. On December 9, 1960, and December 30, 1960, Pearl made payments of \$5,000 and \$14,700 respectively to McCabe and these payments were recorded as sales of feed on McCabe's books. Pearl's cattle consumed \$495.25 worth of feed during 1960 and \$4,822.01 in 1961. Pearl joined Tim when he transferred his entire cattle business to Heber in 1961 and, as a result of this change, a check for \$14,382.74 (the difference between Pearl's December 1960, payments and the total feed consumed by her cattle) was drawn by McCabe to Pearl on July 14, 1961. No provision for refund had been made with McCabe in December, 1960. Pearl continued to raise cattle at the facilities of Heber during the remainder of 1961. (I-R. 17.)

Taxpayers received monthly statements from Heber and McCabe which showed the cost of the feed consumed by their cattle. The cost was charged against their credit balances, which equalled the end-of-year payments less monthly charges. (I-R. 17-18.)

Taxpayers were not required to pay for feed in advance of consumption; nor did they secure any volume discounts, price advantage or preferential treatments from Heber to McCabe because of the large end-of-year payments. Customers of Heber and McCabe could pay monthly for the cost of feed consumed by their cattle and many of them did so. Furthermore, taxpayers were charged for feed consumed at the same price as were all other customers independent of their feeding arrangement. The end-of-year payments made by taxpayers to Heber and McCabe did not secure for them specific quantities or types of feed, nor any other

business advantage. (I-R. 18.) The only advantage sought by taxpayers by the large end-of-year payments was a tax saving. (I-R. 18.)

The price charged for feed by both Heber and McCabe included the cost of extensive and valuable services rendered by the cattle feeding companies. (I-R. 18.)

In his federal income tax returns, Tim claimed the end-of-year payments as ordinary and necessary business expense deductions in the years of payment as shown in the following schedule (I-R. 18-19):

	<u>1959</u>	<u>1960</u>	<u>1961</u>
Cattle sales		\$67,575.24	\$118,135.46
Less-cost of cattle sold		<u>(30,710.41)</u>	<u>(64,705.14)</u>
Gross profit		36,864.83	53,430.32
Less-all expenses (except feed)	\$(4,176.83)	<u>(4,800.90)</u>	<u>(7,114.16)</u>
Profit (loss) before feed expenses claimed	(4,176.83)	32,063.93	46,316.16
Feed expense claimed	<u>(25,000.00)</u>	<u>(52,522.39)</u>	<u>(53,000.00)</u>
Net loss claimed	\$(29,176.83)	\$(18,458.46)	\$(6,583.84)

The net profit computed on the basis of actual feed costs is as follows (I-R. 19):

	<u>1959</u>	<u>1960</u>	<u>1961</u>
Cattle sales		\$67,575.24	(118,135.46
Less-cost of cattle sold		<u>(30,710.41)</u>	<u>(64,705.14)</u>
Gross profit		36,864.83	53,430.32
Less-all expenses (except feed)	\$(4,176.83)	<u>(4,800.90)</u>	<u>(7,114.16)</u>
Profit (loss) before feed expense	(4,176.83)	32,063.93	46,316.16
Feed expense (feed actually consumed)	<u>(657.65)</u>	<u>(35,949.33)</u>	<u>(23,118.85)</u>
Net profit (loss)	\$(4,834.48)	\$(8,885.40)	\$23,197.31

In his notices of deficiencies to the taxpayers, the Commissioner disallowed the end-of-year payments as deductions in the years paid except for small amounts for feed actually consumed in the years of payment. The deductions, however, were allowed by the Commissioner in the years the feed was consumed and the feeding services rendered. (I-R. 21.)

The Tax Court in a decision reviewed by the full court, unanimously held that the end-of-year payments made to the cattle feeding companies were merely deposits for the purchase of feed and related services to be supplied in subsequent years, and did not constitute current expenses for feed and services. (I-R. 19, 28.) The Tax Court, therefore, accordingly held that the end-of-year payments could not be treated as expenses deductible in the years made, but were deductible as ordinary and necessary business expenses only in the years of their use in defraying the cost of feed and other services. (I-R. 28.)

This petition for review followed.

#### SUMMARY OF ARGUMENT

Section 162(a) of the Internal Revenue Code of 1954 allows as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Even if an expenditure otherwise qualifies as an ordinary and necessary business expense, where (as here) a taxpayer files his returns on the cash method of accounting, the expense is deductible only in the taxable year in which it is "paid". A claimed business expense deduction will therefore be allowable only if the amount is paid for an actual expense of the business for the taxable year involved.



The large end-of-year "payments" made by taxpayers for feed to be supplied and services to be rendered in the future failed to meet the above tests for deductibility because, as the Tax Court unanimously concluded, they were merely deposits against which future expenses would be charged, and therefore did not represent payments for current expenses. The record reveals, as the Tax Court found, that the end-of-year disbursements were not made pursuant to any specific quality or quantity of feed; that they were refundable, and in fact were in substantial part refunded; that a significant portion of the cost of feed was for services to be rendered in the future; and that they did not secure for the taxpayer any business advantage, but only a hoped-for reduction in taxable income. These factors, viewed singly or in combination, fully warrant the Tax Court's determination that the payments in question in reality constituted deposits against future expenses, not current business expenses attributable to the taxable year in which they were claimed as deductions, and were deductible only in the years when the feed and services were supplied.

The decision below is entitled to affirmance on the alternative ground that to allow the taxpayer to deduct the "payments" in the years made, rather than in the years in which the feed was consumed and the services were rendered, would distort, rather than clearly reflect their incomes (as required by Sections 446 and 461 of the Internal Revenue Code of 1954), for the taxable years here involved.

The Tax Court's decision is in accord with the relevant decisions. The cases upon which taxpayers rely are readily distinguishable for the reasons pointed out by the Tax Court.

## ARGUMENT

THE TAX COURT CORRECTLY HELD THAT LARGE END-OF-YEAR PAYMENTS BY TAXPAYERS FOR FEED TO BE CONSUMED AND SERVICES TO BE RENDERED IN SUBSEQUENT YEARS WERE NOT DEDUCTIBLE EXPENSES IN THE YEARS OF PAYMENT

### A. Introduction

The Tax Court in a decision reviewed by the full court unanimously held that large end-of-year payments made by taxpayers to cattle feeding companies were not deductible expenses incurred in the years of payment as claimed by taxpayers, but were, as determined by the Commissioner, deductible only in the years in which the feed was consumed and the services rendered. 6/ The determination of the Tax Court was based on the factual finding that the amounts placed in the hands of the cattle feeding companies near the end of each of the years in question were in reality merely deposits and did not constitute actual expenses for feed and services for those years. The Commissioner submits that the decision below should be affirmed on that ground or alternatively on the ground that, as additionally urged by the Commissioner below, but not passed upon by the Tax Court (I-R. 28-29), allowance of the claimed deductions would materially distort taxpayers' income in the years in question.

### B. A deposit for the payment of feed and related services is not a current business expense and therefore may not be deducted from current taxable income

The Tax Court's holding that deposits for payment of future purchases of feed and related services could not be deducted in the years

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6/ Thus, a deduction in the year of payment was allowed for the small amount of feed and services actually supplied in that particular year. For example, a \$25,000 payment was made in December, 1959, by Tim to Heber whereas his cattle consumed only \$657.65 worth of feed at Heber's in 1959. (I-R. 2.) Only the latter amount was allowed by the Commissioner as a deduction in 1959.



in which they were made is completely consistent with Sections 162, 446 and 461 of the Internal Revenue Code of 1954 (Appendix, infra), as well as the decided cases considering the point. 7/

Section 162 of the 1954 Code provides:

SEC. 162. TRADE OR BUSINESS EXPENSES.

(a) In General.--There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including--

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(26 U.S.C. 1964 ed., Sec. 162.)

These words clearly state that a deduction will be allowed only if the amount paid is for an actual expense of the trade or business. If an amount is paid as a deposit against future expenses, it does not meet the test - it is not paid for a current expense. 8/ The burden of proof is on the taxpayer to show that he has incurred a deductible

7/ The courts have not looked favorably on attempts by cash basis taxpayers to deduct advance payments (to say nothing of mere deposits) for expenses of subsequent years. See for example Main & McKinney Bldg. Co. v. Commissioner, 113 F. 2d 81 (C.A. 5th), certiorari denied, 311 U.S. 688; Baton Coal Co. v. Commissioner, 51 F. 2d 469 (C.A. 3d), certiorari denied, 284 U.S. 674; Galatoire Bros. v. Lines, 23 F. 2d 676 (C.A. 5th); Commissioner v. Boylston Market Ass'n, 131 F. 2d 966 (C.A. 1st); Peters v. Commissioner, 4 T.C. 1236; and Automatic Fire Alarm Co. v. Commissioner, 13 B.T.A. 1195.

8/ Section 162 is intended primarily to cover expenditures of a recurring nature where the benefit derived from the payment is realized or exhausted within the taxable year. Accordingly, if as the result of the expenditure, a taxpayer acquires an asset which has an economically useful life beyond the taxable year, no deduction for such payment is allowable as a business expense. See 4A Mertens, Law of Federal Income Taxation, Section 25.20, and the citations contained therein. Moreover, even though an expenditure may result in the acquisition of an asset which has a life of less than one year, it may nevertheless not be deductible if not paid or incurred in currently carrying on the taxpayer's business and if not both ordinary and necessary to the current conduct of such business. General Bancshares Corp. v. Commissioner, 326 F. 2d 712 (C.A. 8th), certiorari denied, 379 U.S. 832.



expense (Interstate Transit Lines v. Commissioner, 319 U.S. 590, 593; E.&J. Gallo Winery v. Commissioner, 227 F. 2d 699 (C.A. 9th)) and the determination whether these expenditures are ordinary and necessary business expenses is a question of fact (Commissioner v. Heininger, 320 U.S. 467). As stated by the United States Court of Appeals For the First Circuit in Russell Box Co. v. Commissioner, 208 F. 2d 452, 454:

When all is said, the fact remains that close cases have to be decided by the Tax Court one by one as individual instances, and that our function is to reverse the Tax Court only when we are concerned that its conclusion in a particular case is clearly erroneous.

See also Wohl v. United States, 267 F. 2d 605 (C.A. 5th), certiorari denied, 361 U.S. 931; Wells-Lee v. Commissioner, 360 F. 2d 665 (C.A. 8th).

We submit that the record amply supports the Tax Court's unanimous conclusion that the end-of-year "payments" were merely deposits and therefore not deductible as expenses of the year in which they were made.

First, as found by the Tax Court, the advance payments did not secure for the taxpayers any business advantage other than a substantial reduction in taxable income.<sup>9/</sup> (I-R. 18.) This reduction resulted from the offsetting of large amounts of income received from other sources<sup>10/</sup> by large losses

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<sup>9/</sup> Taxpayers now admit that one of the reasons for making the end-of-year payments was to obtain the tax advantage. (Br. 18.) Earlier, Tim had denied that in making the large end-of-year payments, the tax aspect was considered at all. (II-R. 28-29.) Pearl likewise denied that the tax aspect was considered. (II-R. 142-143.)

<sup>10/</sup> In the case of Tim, the source was his dental practice. (I-R. 13.) Whereas, in the case of Pearl, it was interest payments from Tim. (I-R. 14.)

incurred in the cattle-feeding business (I-R. 13-14), which losses were primarily due to the taking of deductions for feed expenses in the year payments were made, rather than in the year the feed was consumed (I-R. 19). Taxpayers suggest that a price advantage was obtained by making the payments. However, the Tax Court specifically found that the taxpayers received no price advantage by making the end-of-year payments during the year in issue,<sup>11/</sup> that no volume discount was received by virtue of the payments,<sup>12/</sup> that customers of Heber and McCabe could pay monthly for the cost of feed consumed by their cattle and many did so,<sup>13/</sup> that taxpayers were not required to pay for feed in advance of consumption<sup>14/</sup> and that taxpayers were charged for feed consumed at the same price as were all other customers independent of their feeding arrangements.<sup>15/</sup> (I-R. 18.) Nor was any preferential treatment given taxpayers because of the end-of-year payments.<sup>16/</sup> (I-R. 18.) Moreover, the Tax Court found that no business reason existed for making the advance payments and also found that there was no shortage of feed when the end-of-year payments were made. (I-R. 18, 27.)

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<sup>11/</sup> See testimony. (II-R. 78-102.)

<sup>12/</sup> Tim so testified (II-R. 31) and Jack William, manager of McCabe, so testified (II-R. 113).

<sup>13/</sup> Virgil Torrence, a partner and general manager of Heber, so testified (II-R. 68), and Jack William so testified (II-R. 112-113.)

<sup>14/</sup> See testimony of Virgil Torrence. (II-R. 68-69.)

<sup>15/</sup> See testimony (II-R. 78-102) and the Supplemental Stipulation of Facts (I-R. 8-10).



Second, taxpayers purchased no specific quality or quantity of feed. Rather, as the various feeds were used, the current market prices for the feeds consumed were charged against taxpayers' then existing credit balances.<sup>17/</sup> (I-R. 27.) For example, on December 21, 1959, Tim made a payment of \$25,000 to Heber and received an invoice which stated that he had purchased 500 tons of Number 1 mix. (I-R. 15.) However, from December, 1959 to March, 1960, Tim's cattle consumed approximately 59 tons of number 1 mix, 12 tons of number 2 mix, 117 tons of number 4 mix, and 136 tons of silage. The costs of these different types of feed (which varied from \$12 to \$50 per ton) were charged against the \$25,000 payment. Moreover, medical supplies were also charged against the \$25,000. (Ex. 10-J; II-R. 39-44.)

That the end-of-year payments did not represent payment for any specific quality or quantity of feed is further shown by the end-of-year payment made in 1961 in the amount of \$52,520.23; which Tim took as a deduction in 1961. (I-R. 17, 19.) During the years 1961 and 1962, taxpayers were on the "pounds gained by cattle" method of payment to the cattle feeders. (Ex. 11-K; II-R. 47-49.) This was a method whereby the cattle feed companies charged their customers a specific price per pound for each pound gained by the customer's cattle. (II-R. 89.) Heber charged Tim for the weight so gained and applied such charge against the \$52,520.23 payment which taxpayers claim was for the purchase of a specific quality and quantity of feed.<sup>18/</sup> That the \$52,520.23 payment

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<sup>17/</sup> Credit balances were the amount of the end-of-year payments less subsequent monthly charges. (I-R. 18.)

<sup>18/</sup> The fact that taxpayers and the cattle feeding companies treated the transaction on their books as sales is not controlling. The real facts, not bookkeeping entries, must control the determination of taxable income. Doyle v. Mitchell Brothers Co., 247 U.S. 179.



in December, 1961, did not represent the purchase of feed could not be made clearer.

Third, during 1961, Tim had a disagreement with the manager of McCabe where he had been maintaining two herds of varying size. He then decided to transfer all of his business to Heber. Consequently, on or about July 10, 1961 (some two months after the last of the cattle which had been kept at McCabe had been sold), McCabe gave Tim a check for \$26,140.57, which represented the difference between Tim's end-of-year payments in 1960 of \$42,160 and the amount of feed (\$16,009.94) consumed by his cattle at McCabe.<sup>19/</sup> (I-R. 16.) If taxpayers' argument that the end-of-year "payments" were deductible in the year paid were accepted, it would result in Tim understating his income for 1961 in the amount of \$26,140.57; i.e., the amount of the refund from McCabe. This understatement of income results from the fact that in 1960, Tim took a deduction of \$42,160 for the end-of-year payments in that amount. (I-R. 16, 18.) Included in the payments was the \$26,140.57 which McCabe subsequently refunded to Tim. Then, in 1961, Tim took a further deduction for end-of-year "payment" in the amount of \$53,000 (I-R. 19) which was composed of \$52,520.23 paid to Heber in 1961 and \$479.77 paid to McCabe that same year (I-R. 4). Nowhere, however, did Tim report or in any manner reflect the return of the \$26,140.57 for which a deduction had been taken in the prior year, 1960. (Ex. 8-H.) Tim therefore grossly overstated his

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<sup>19/</sup> An additional \$9.49 was charged against Tim's payment as the fee for a branding inspection. (I-R. 16.)

cost of feed in 1960, or else understated his income for 1961 (even assuming the end-of-year payments to be deductible in the year made).<sup>20/</sup> If the decision of the Tax Court is upheld, the return of the \$26,000 would be considered merely as the return of a deposit, with no resulting overstatement of deductions in one year or understating of income in a subsequent year.

Moreover, the very fact that the deposits were refunded in one out of three tax years with which Tim is concerned and in the only tax year with which Pearl is concerned negates taxpayers' claim that the end-of-year payments represented payments for completed sales; for, if there had actually been payments for sales of feed involved rather than deposits, the amount refunded to taxpayers by McCabe should have been less than their credit balances. This is so because if McCabe were purchasing back feed previously sold to the taxpayers, it would not have paid as much as did the taxpayers since the taxpayers would have purchased both feed and services whereas McCabe would be purchasing back only feed. McCabe, however, "paid" the taxpayers the full amount of their credit balances remaining on its books, clearly indicating thereby that McCabe was merely returning taxpayers' deposits.

Fourth, a substantial portion of the end-of-year payments was for services to be rendered in the subsequent year, and hence represented merely deposits against which future charges for such services could be made. The cost of feed included the cost of substantial services rendered by the cattle feeding companies. The services were performed in order

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<sup>20/</sup> Pearl received a refund in 1961 from McCabe in the amount of \$14,382.74. (I-R. 17.) The tax treatment in that year of the amount so refunded is not in question as only Pearl's 1960 tax year is involved in this case.



to increase sales of feed and were in fact so complete that some cattle owners never saw their stock. Among the services performed by the cattle feeding companies were unloading, branding, dipping, weighing, dehorning, castrating, recording and placing the cattle in proper feeding pens. Throughout the months during which the cattle were being fattened, company employees would mix the proper feeds and deliver them to the herds twice daily. After sale, the feeding companies would load the cattle and direct shipment to the meat packing houses. (I-R. 14.) Thus, services were being rendered throughout the entire period in which the cattle were at the cattle feeding company, and a substantial part of the advance "payments" in question was for future services.

Taxpayers place great reliance on the cases of Ernst v. Commissioner, 32 T.C. 181, and Cravens v. Commissioner, 272 F. 2d 895 (C.A. 10th). We submit, as the Tax Court found, that Ernst and Cravens are factually distinguishable from the instant case. (I-R. 27.)

In Ernst, the taxpayer was a poultry farmer who made substantial payments in 1948 and 1949 to a grain dealer who became obligated to deliver quantities of chicken feed to the taxpayer during the succeeding years. The payments were for the purchase of a certain number of cars of feed and bags of scratch, the price of which was to be adjusted at the date of shipment. Deliveries were made by the grain dealer in the early months of 1949 and 1950, at which time charges were made against the taxpayer's account receivable card. The charges were determined by the quantity of the deliveries and the prevailing price on the weekly wholesale price list. The taxpayer had no right to a return of any of the payments made. On these facts, the payments were held to be deductible in the years of payment.



Several factors distinguish the instant case from Ernst.

First, taxpayers here actually received a refund of the deposits, whereas, in Ernst, the taxpayer had no right to a return of any of the payments made.

Second, the price of feed in the present case included the cost of a significant amount of services to be rendered in the future (including the feeding of the cattle) whereas, in Ernst the poultry was fed on the taxpayer's own farm and no services were rendered by the supplier of the feed.

Third, the payments in Ernst were for the purchase of a certain number of cars of feed and bags of scratch. In the instant case, no specific quantity and quality of the feed was "purchased" by virtue of the deposits. (I-R. 18.) Rather, various mixes, silage and alfalfa were charged against the deposit, as were also medical supplies. Furthermore, in those years where taxpayers were on the "pounds gained by cattle" method, the costs so incurred by taxpayers were charged against the end-of-year payments which supposedly were, as argued by taxpayers, solely for the purchase of feed. These costs were, however, for the increased value of the cattle (as represented by their gain in weight) and could hardly be considered to be for the cost of feeds.

Fourth, in Ernst the taxpayer's primary source of income was from his poultry farm and the deduction for feed in the year of payment did not materially distort his income. Here, Tim's primary source of income was his dental practice (I-R. 13) and Pearl's primary source was interest payments from Tim (I-R. 14). The effect of the deductions being taken

in the year the payments were made, rather than in the year the feed was consumed and the services rendered, was to totally offset Pearl's interest income and to enable Tim to report large losses which offset substantial amounts of income from his dental practice. (I-R. 13-14.)

Likewise, Cravens v. Commissioner, supra, is distinguishable from the instant proceeding. In Cravens, the taxpayer operated a cattle ranch. In 1953, because of a drought and an impending shortage of cattle feed, the taxpayer gave his feed supplier \$50,000 as an advance payment on 745 tons of feed. Delivery was to be made as the taxpayer placed his orders, and the price was to be the market price prevailing on the delivery dates. If the advance payment exceeded the ultimate cost, the taxpayer was entitled to a refund. The feed supplier was unable to guarantee delivery, but did agree to fill the taxpayer's order first in the event of shortages. A deduction for 1953 in the amount of \$50,000 was upheld by the Court of Appeals for the Tenth Circuit.

Several factors also distinguish the present case from Cravens.

First, the primary basis for the decision in Cravens appears to be that the taxpayer there had a compelling business reason in that a drought threatened to terminate his supply of feed and the payment secured preferential treatment for him. No such need or preferential treatment has been shown in the present case. In fact, the Tax Court specifically found that there was no shortage of feed (I-R. 27) and that the end-of-year payments secured no preferential treatment for taxpayers (I-R. 18).

Second, in Cravens the cost of feed did not include the value of services, as the cattle were feed at the taxpayer's ranch. Here, the taxpayers' cost of feed included valuable and significant services to be rendered by both of the cattle feeding companies. Thus, a portion of the deposit was in essence a deposit for the payment of services to be supplied in the future.

Third, the taxpayer in Cravens never received a refund or return of his payment, whereas, these taxpayers received what amounted to substantial refunds.

Fourth, in Cravens the taxpayer ordered a specific quantity of feed. Here, the taxpayers in actuality did not order a specific quantity, but, were charged for various feeds and mixes as they were consumed by the cattle. Furthermore, medical supplies were charged against the payments which taxpayers now claim to have been solely for feed. And, when it is noted that the advance payments or deposits continued when taxpayers were on the "pounds gained by cattle" method of paying for the feeding and servicing of their cattle, it becomes quite clear that the end-of-year payments were not for the purchase of specific quantities of feed.

In rejecting taxpayers' claim that Ernst and Cravens are controlling, the Tax Court stated (I-R. 28):

Notwithstanding petitioners' heavy reliance on Ernst and on the Tenth Circuit's opinion in Cravens, we lack the pioneering spirit to extend the frontier of the factual conclusions reached in those decisions to cover the different facts before us in these cases. Suffice it to say that neither Ernst nor Cravens is controlling here.



In Shippy v. United States, 308 F. 2d 743 (C.A. 8th), the latest case on this particular subject, the taxpayers were members of a partnership engaged in a cattle and hog feeding business with income being reported on the cash basis. On December 28, 1957, the partnership made a \$23,000 payment to a grain elevator operator for feed to be delivered in the future as needed by the partnership in its feeding operations. Feed was supplied to the partnership from time to time in 1958, at the price in effect on the date of each delivery, until the entire \$23,000 was exhausted in July of that year. The District Court (199 F. Supp. 842 (W.D. S.D.)) held the payment was not an ordinary and necessary business expense in 1957 (the year of payment), but an advance deposit to cover future purchases of grain. In so holding, the District Court stated (p. 843):

\* \* \* this large advance deposit for future delivery of feed could hardly be termed "ordinary." Neither was it "necessary." The reasons advanced by the partnership as to the necessity of the advance deposits are not convincing. There was no shortage of feed. Advance payment was not and never had been demanded by the elevator. The elevator's commission paid by the partnership was the same as it had always paid, and the advance deposit assured it of no preferential treatment it could not have had without such deposit.

The arrangement made between the partnership and the elevator was not a contract. It was an advance deposit for future purchases of feed. We do not believe that Congress intended that taxpayers should be allowed to "juggle" their liability in this manner.

In affirming the decision of the District Court, the Court of Appeals for the Eighth Circuit stated (supra, pp. 747-748):21/

\* \* \* the partnership did not have a binding contract to purchase wet corn or other grain. It did not actually buy grain. It made only an advance deposit which would have been refunded upon request. Therefore, the disbursement was not an ordinary and necessary expense paid in the year 1957 in the carrying on of its trade or business.

In commenting on the Shippy decision, the Tax Court in the instant proceeding stated (I-R. 28):

We believe these facts [in the instant case] present a stronger case than Shippy, except for the specific finding in that case that the seller considered the payment a deposit. Again we emphasize the inclusion of services in the cost of feed to be consumed by petitioners' cattle in the future and the sizeable refunds received by both petitioners from McCabe in 1961.

The Commissioner is in full agreement with the Tax Court that this case presents a stronger case for the Government than did Shippy; for, as in Shippy, quantity, quality and price of the feed to be consumed by taxpayers' cattle were unknown at the time the payments were made. However, in Shippy the cost of feed did not, as it did here, include services to be rendered by the feeding companies; the taxpayer in Shippy did not obtain any refund as did taxpayers here; and as the feed company in Shippy was not performing any services, the cost of "pounds gained by cattle" could not be, as was the case here, charged against the end-of-year payment.

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21/ The Court of Appeals deemed it unnecessary to reach and discuss alternative grounds upon which the District Court based its decision.



C. Allowance of the claimed deductions in the years of payment would materially distort taxpayers' net incomes for those years

As stated in the Introduction (Part A, supra), the decision below is entitled to affirmance on the alternative ground that allowance of the claimed deductions in the years of "payment" would materially distort taxpayers' net incomes for those years.<sup>22/</sup> And, as pointed out above (Part B) in support of the Tax Court's conclusion that the "payments" in reality represented deposits against future purchases and services, a substantial part of which was refunded in a later year, to sanction the claimed deductions would distort taxpayers' incomes--either by an overstatement of deductions in the year of payment, or an understatement of income in the year of refund.

Indeed, taxpayers' incomes here were distorted to a greater degree than in Shippy. In that case, if the payment had been allowed as a deduction in the year in which it was paid, the taxpayer's income over a period of years would have been \$5,000, \$24,000, \$12,000 (year of payment) and \$8,000; whereas, when the payment was disallowed as a deduction in the year paid, the taxpayer's income was \$5,000, \$24,000, \$35,000 (year of payment) and (\$15,000). In the present case, Tim's income from his dental practice was as follows (I-R. 13):

<u>Year</u>	<u>Amount</u>
1956	\$26,778.25
1957	31,490.72
1958	28,058.91
1959	24,647.67
1960	10,244.54
1961	19,115.32

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<sup>22/</sup> The Commissioner urged this alternative ground below, but the Tax Court considered it unnecessary to pass upon it in view of its conclusion that the payments did not constitute currently deductible business expenses. (I-R. 28-29.)



His reported losses from the cattle business, which resulted primarily from taking deductions for the end-of-year payments in the year paid rather than in the year when the feed was consumed and the services rendered were as follows (I-R. 13):

<u>Year</u>	<u>Amount of net (loss)</u>
1959	(\$29,176.83)
1960	(18,458.46)
1961	(6,683.84)

If, however, the cost of feed had been computed on the basis of actual feed costs, the net profit from Tim's cattle business would have been as follows (I-R. 19):

<u>Year</u>	<u>Amount of net (loss)</u>
1959	(\$4,834.48)
1960	(3,885.40)
1961	23,197.31

The same situation exists in Pearl's case. In her 1960 federal income tax return, she reported income of \$21,226.93 which included interest payments received from Tim in the amount of \$18,444. At the same time, she reported a net loss from her cattle operation in the amount of \$20,402.1 of which \$19,700 was due to end-of-year payments made in December of 1960. (I-R. 14.) Thus, Pearl likewise timed the large end-of-year payment so as to attempt to offset the large interest payment received from Tim that same year.

In short, end-of-year payments were ordinary and necessary business expenses only for those years in which the feed was consumed and the service rendered - and were allowed as deductions for those years. They

were properly disallowed as deductions in the years of payment either on the ground that the payments merely represented deposits and as such were not ordinary and necessary expenses within the meaning of Section 162 for the taxable years in which paid or, alternatively, on the ground that the deductions resulted in a distortion of taxpayers' incomes and therefore failed to clearly reflect income as required by Sections 446 and 461 of the Internal Revenue Code of 1954 and Sections 1.461-1(a)(1) and (3)(i) of the Treasury Regulations (Appendix, infra).

#### CONCLUSION

The decision of the Tax Court is correct and should be affirmed.

Respectfully submitted,

RICHARD C. PUGH,  
Acting Assistant Attorney General.

LEE A. JACKSON,  
HARRY BAUM,  
STEPHEN H. PALEY,  
Attorneys,  
Department of Justice,  
Washington, D. C. 20530.

OCTOBER, 1966.

#### CERTIFICATE

I certify that, in connection with the preparation of this brief, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

Dated: \_\_\_\_\_ day of \_\_\_\_\_, 1966.

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Attorney

APPENDIX

Internal Revenue Code of 1954:

SEC. 162. TRADE OR BUSINESS EXPENSES.

(a) In General.--There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including--

(1) a reasonable allowance for salaries or other compensation for personal services actually rendered;

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(26 U.S.C. 1964 ed., Sec. 162.)

SEC. 446. GENERAL RULE FOR METHODS OF ACCOUNTING.

(a) General Rule.--Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

(b) Exceptions.--If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income.

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(26 U.S.C. 1964 ed., Sec. 446.)

SEC. 461. GENERAL RULE FOR TAXABLE YEAR OF DEDUCTION.

(a) General Rule.--The amount of any deduction or credit allowed by this subtitle shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income.

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(26 U.S.C. 1964 ed., Sec. 461.)



Treasury Regulations on Income Tax (1954 Code):

Sec. 1.461-1 General rule for taxable year of deduction.

(a) General rule.--(1) Taxpayer using cash receipts and disbursements method. Under the cash receipts and disbursements method of accounting, amounts representing allowable deductions shall, as a general rule, be taken into account for the taxable year in which paid. Further, a taxpayer using this method may also be entitled to certain deductions in the computation of taxable income which do not involve cash disbursements during the taxable year, such as the deductions for depreciation, depletion, and losses under sections 167, 611, and 165, respectively. If an expenditure results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year, such an expenditure may not be deductible, or may be deductible only in part, for the taxable year in which made. An example is an expenditure for the construction of improvements by the lessee on leased property where the estimated life of the improvements is in excess of the remaining period of the lease. In such a case, in lieu of the allowance for depreciation provided by section 167, the basis shall be amortized ratably over the remaining period of the lease. See section 178 and the regulations thereunder for rules governing the effect to be given renewal options in determining whether the useful life of the improvements exceeds the remaining term of the lease where a lessee begins improvements on leased property after July 28, 1958, other than improvements which on such date and at all times thereafter, the lessee was under a binding legal obligation to make. See section 263 and the regulations thereunder for rules relating to capital expenditures.

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(3) Other factors which determine when deductions may be taken. (i) Each year's return should be complete in itself, and taxpayers shall ascertain the facts necessary to make a correct return. The expenses, liabilities, or loss of one year cannot be used to reduce the income of a subsequent year. A taxpayer may not take advantage in a return for a subsequent year of his failure to claim deductions in a prior taxable year in which such deductions should have been properly taken under his method of accounting. If a taxpayer ascertains that a deduction should have been claimed in a prior taxable year, he should, if within the period of limitation, file a claim for credit or refund of any overpayment of tax arising therefrom. Similarly, if a

taxpayer ascertains that a deduction was improperly claimed in a prior taxable year, he should, if within the period of limitation, file an amended return and pay any additional tax due. However, in a going business there are certain overlapping deductions. If these overlapping items do not materially distort income, they may be included in the years in which the taxpayer consistently takes them into account.

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(26 C.F.R., Sec. 1.461-1.)